SOME POINTS IN OPPOSITION TO THE ALDRICH PLAN[1]

When in January of this year Mr. Aldrich gave out his plan for banking reform and invited discussion and criticism, he performed an act of heroism in a great cause which entitles him to the thanks and admiration of his countrymen. Whether the plan ever becomes a law or not, the service done will be of inestimable value.

No one expects it to become law without opposition. An enemy of the plan might keep still and wait for the final report to Congress of the Monetary Commission. Its friends are those who state their objections now. It is in this latter spirit that I criticize some fundamental features of the plan.

It does not seem to be so well understood as it ought to be that the proposed Reserve Association has two distinct functions. One is that of a great financial institution carrying on the regular business of everyday banking for profit, receiving deposits, loaning money, buying and selling exchange, and issuing its own notes. The other is that of providing a way by which banks can use their united credit in times of danger to meet any emergency, so that there need be no fear at such times of either suspension of payments or demoralizing contraction of credits. Those two functions have little to do with each other. The protective feature which would be of greatest use in time of crisis, necessarily lies dormant under normal conditions.

I wish to make it clear at the outset that my criticism is directed solely at the functions which the association may perform in normal times, and not at the functions which it would be called upon to perform in a time of crisis. Those things which are proper and necessary to be done in an emergency may be harmful and dangerous under normal conditions, and my belief is that the opportunity for credit inflation which would be afforded by this plan under normal conditions would be not only unnecessary, but dangerous.

The plan is to concentrate in the Reserve Association the cash

[1] A paper read before the Western Economic Society at Chicago, November 11, 1911.

reserves now held by the banks, and to use this fund as a basis for an issue of credit currency which would eventually become our principal circulating medium. It would be an association of the banks not only for the purpose of mutual protection, but also for the purpose of capitalizing and exploiting their combined credit and good-will so that it could be loaned to those members of the association who would be willing to pay for it. That the adoption of such a plan would lead almost immediately to unexampled prosperity and business activity I have no doubt, but would it not be the dangerous form of prosperity and activity that always follows inflation?

Mr. Aldrich says that under this plan banks will be able to "replenish their reserves indefinitely." This is equivalent to saying that banks may expand their loans indefinitely. So long as the Reserve Association stands ready at all times to convert commercial paper into circulating notes which can be used by the banks to purchase more commercial paper, which in turn could be converted into circulating notes and so on, it would seem that there would be little check on inflation except such self-restraint as each individual bank might be able to exercise.

As an illustration of what could be done with this plan in operation: Our largest bank here in Chicago would be entitled to borrow fifty millions of dollars from the association in the ordinary course of business if it could furnish enough commercial paper having not more than twenty-eight days to run. In addition to this, it could accep the paper of its customers to the amount of fifteen millions which could be sold to the association. That is, this bank would have the power of expanding its liabilities sixty-five millions of dollars on its own motion, without curtailing its right to call upon the association for unlimited credit in an emergency.

Assuming that the plan was in operation and that all the banks in the country that are now eligible became members of the association, they would at once have the right to borrow from the association approximately six billions of dollars, and, in addition to this, would have the right to accept the paper of business concerns to the amount of nearly two billions of dollars. All this without contracting in any way their present borrowing facilities.

Bear in mind that this sudden addition to the powers of credit expansion, amounting to nearly eight billions of dollars, is not intended for emergency use only, but as a function to be exercised by the association under normal conditions and in the course of everyday business. Whenever in the opinion of the managers of the association the public interests so require, banks may, in addition to all this, discount their direct obligations with the association. To this there is no limit whatever. If there are any who think all this does not invite overextension of credit, I cannot agree with them.

It is obvious that under present conditions no great harm would be done, as the banks do not hold enough paper maturing inside of thirty days to make the possibility of inflation serious. The plan, however, is designed to create in this country a great discount market which does not now exist, and to create an entirely new class of commercial paper which does not now exist. The only way such paper could get into the Reserve Association would be through the banks, and the only way the banks could get it into the Reserve Association would be by discounting it. Banks would discount such paper with the association simply for the profit there would be in it. The great demand that would arise for short-time paper would naturally increase the supply. With the co-operation of the note brokers, it would be a simple matter to keep a large volume of short-time paper turning over in the association.

When the plan was first published, many leading bankers who are now supporting it said there should be some safeguard against inflation of credit. If on further study of the plan they have found some safeguard that was overlooked at first, they should give the rest of us, who are unable to find it, the benefit of their discoveries.

Since the plan was made public the Currency Commission of the American Bankers' Association has proposed certain amendments which are not intended in any way to check expansion, but rather the contrary. Mr. Aldrich in the latest revision of the plan says it was deemed necessary "to provide such effective regulation of discounts and note issues as would enable the organization to respond promptly at all times to normal or unusual demands for

credit or currency without danger of undue expansion or inflation." Is this not a self-contradictory statement? How can you respond promptly at all times to both normal and unusual demands for credit or currency without danger of undue expansion or inflation?

The only regulation suggested in the revision is a tax to be paid by the association on any deficiency in its reserves or excess in its note issues. It is naturally expected that the imposition of the tax will raise the discount rate, but the experience in Germany has been that the bank rate, established from time to time by the Imperial Bank, is governed by general conditions and not by the tax. The tax being levied only on the excess of circulation is a very small tax on the total amount outstanding, so that the bank can make satisfactory profits by loaning money at a less rate than the tax.

One of the most vital features of the Aldrich plan is that banks having a credit on the books of the Reserve Association shall be permitted to count that credit as a part of the cash reserve required by law, so that under this plan they would need to carry no cash in their vaults whatever for reserve purposes. This credit with the association would be a second lien on its assets, the vast amount of outstanding notes being a first lien.

When the plan was first put out it was evidently not intended to permit banks to count Reserve Association notes as part of their cash reserves, but the absurdity of permitting a second lien in unavailable form to be counted as reserve and to prohibit its use as reserve the moment it becomes a first lien and in available form is so obvious that it became necessary to abandon either a vital feature of the plan or an established principle of sound finance. Between the horns of this dilemma the established principle of sound finance seems to have been worsted.

Most of the essential features of this plan have been copied from the German banking system, Germany being the only country of the first class where bank-note issues are based on commercial paper. This fortunately enables us to study the plan in operation.

The Imperial Bank of Germany was opened for business in 1876. It may be worth mentioning parenthetically that the German government did not deposit all its gold with the bank, but put away one hundred and twenty million marks in gold in the Fortress of Spandau, not being willing apparently to take the

chance of getting gold from the bank when it might be needed in an emergency. The gold is there yet.

Since the Imperial Bank has been in operation Germany has enjoyed an era of industrial expansion and prosperity unequaled in history. For some years past, however, symptoms of overexpansion have grown more and more acute. Instead of recovering rapidly from the crisis of 1907, the situation there has been getting more and more out of hand, until today, with a world-wide condition of ease in money, the Imperial Bank of Germany is apparently unable to cope with the situation. Both the German government and the great German banks are borrowing immense sums of money at high rates from the despised American banks, and the German banks have been obliged to announce a partial suspension of payment at the times of quarterly settlement. Those who have been allured by the vision of cheap money in the Aldrich plan should consider carefully the fact that our banks are today loaning money to the great German banks at rates which are higher than they are charging at home to ordinary commercial customers. Statistics show that for the past ten years interest rates in Germany have averaged higher than in either France or England, and that financial operations have been conducted there with greater difficulty in times of trouble.

In the discussions of the plan not enough attention, I think, has been paid to the interests of the ordinary depositor who is neither a banker nor a borrower. He may not take kindly to the plan of providing an easy way by which the commercial paper, in which his savings have been invested by the banks, can be hypothecated with the Reserve Association and thus put beyond his reach in case of failure. The bank examiners seem to agree that the greatest source of weakness and danger among a certain class of banks is their proneness to borrow money in every way possible by hypothecating their available assets, so that when they fail the depositor has to wait a long time for equities to be realized upon before he gets anything.

That there should be a plan, however, to enable banks to use their credit when the necessity for it arises is admitted by everybody. The idea embodied in the Aldrich plan of combining all the banks into local associations for this purpose is ideal, and so clearly

in the line of development that it ought to be adopted whether the plan as a whole is adopted or not. With the present clearing-houses as nuclei, all the banks in the country could be readily united into local associations. These associations could be given power when necessary to borrow currency from the government with the security of commercial paper in the manner provided for in the so-called Aldrich-Vreeland law. Such currency should be taxed, and as this tax would fall directly on the banks taking it out, the currency would be retired when not needed. Such a plan would probably meet with little opposition, although many would say that it does not go far enough to cure all the defects of our system. It would, however, give us all the protection in time of danger that the plan under discussion promises, without introducing radical and fundamental changes into our commercial system, the results of which no one is wise enough to foresee.

If clearing-house associations were once organized under a federal law, a Reserve Association might come in the natural process of evolution. However, if we must have the Reserve Association, why not make it a combination of the Bank of England and the Bank of Germany? Let it be run like the Bank of England in normal times, with a solid gold reserve back of its notes, and with the power to issue notes against commercial paper only under certain restrictions. Credit currency of that sort is needed only in emergencies, as our present machinery furnishes all the credit that is good for us in normal times.

ADDENDUM

Mr. Aldrich in his speech before the Western Economic Society on November 11 took occasion to criticize this paper sharply on the ground that the proposed tax would be an absolute check on inflation. He ridiculed the idea of a six-billion-dollar inflation, as he said the tax would become prohibitive long before any undue inflation could take place.

Let us see about this. Let us suppose that the Reserve Association is organized and ready for business. Bank A takes one million dollars out of its cash reserve and deposits it with the association for its credit. Having the credit with the association it may continue to count this million dollars as part of its own cash reserve.

Against this one million the Reserve Association may issue from one to three million of its own notes. Say it issues one million and loans the notes to Bank B. Bank B may count these notes as legal reserve and lawfully expand its loans four million dollars on the strength of it. The situation in the Reserve Association is that the association owes Bank A one million dollars on open account and Bank B one million dollars on its notes, making demand liabilities of two million dollars against which it holds the one million dollars of gold deposited by Bank A, this gold under the plan being counted as reserve in all three places. Thus, having its demand liabilities covered by a 50 per cent reserve, the Reserve Association is subject to no tax whatever. This one million dollars under our present system stands as reserve in Bank A for four million dollars deposits, or as a basis for four million dollars in loans. With the Reserve Association in operation it would serve exactly the same purpose in Bank A, and at the same time would serve as a reserve for two million dollars of liabilities of the Reserve Association and four million dollars of liabilities of Bank B, an expansion of six millions of dollars with no tax in operation.

I am aware that there are those who deny that an addition to our reserve money makes a basis for a much larger addition to loans. This is simply quarreling with facts. Bank loans and bank deposits are interchangeable forms of credit. A loan in one bank becomes a deposit in another. The only limit to the expansion of both is the proportion that they must bear to the amount of reserve money held by the banks.

The banks of the country eligible to membership in the proposed association hold today legal cash reserve, according to Mr. Aldrich, of fifteen hundred millions of dollars, and it is claimed that about one billion of dollars of this would be deposited with the Reserve Association as it could still be counted as reserve cash by the depositing banks. Following this through the same process of financial juggling described above, we arrive at the result of a six-billion-dollar expansion without any tax whatever. These figures are based on the assumption that all banks carry 25 per cent cash reserves. As a matter of fact, banks outside of reserve cities are only required to carry 6 per cent cash reserves, thus being enabled to expand their issues sixteen times the amount of their cash

reserve instead of four times. Hence the possibilities of expansion are much greater than the above figures indicate.

The assumption that there can be no expansion except what would be represented dollar for dollar by Reserve Association notes is absurd, and no one knows this better than Mr. Aldrich. We need expansion of credit in a crisis to overcome the tendency to violent contraction that always appears at such times, and those who argue that the proposed Reserve Association would furnish just such expansion as we would need will find few to differ with them. On the other hand, in times of prosperity and optimism when business is "booming," where is the check? Mr. Aldrich says that under his plan "banks may replenish their reserves indefinitely" and that such regulation of note issues and discounts have been provided as will "enable the organization to respond promptly at all times to normal or unusual demands for credit or currency." Yet he resents hotly the suggestion that this spells inflation. He says: "There is no limit at all on expansion in England or Germany, and in France it is so far in excess of possibilities that there might as well be none." Mr. Aldrich must know that the Bank of England cannot issue over ninety million dollars of currency without a gold sovereign behind every pound note outstanding. Is not this a limit on expansion? It seems to the writer that there is a great difference between limiting expansion to the amount of gold in the country and limiting it to the amount of commercial paper.

Mr. J. B. Forgan, in his recent New Orleans speech, quoted with approval a passage from a speech made by Mr. Perrin of Indianapolis containing these words: "It [the Reserve Association] would have such vast credit-extending power as to be almost beyond belief and certainly far beyond requirements in any panic."

Mr. Aldrich in his speech before the Western Economic Society said: "Now if it were true that this plan could or might result in the extension of six thousand millions of credit, why certainly that is a pretty serious claim, it would be a very serious objection to the plan."

Surely there is something here that needs straightening out.

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